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NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

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April 5, 1982

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MEMORANDUM FOR:

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Department of State

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Executive Secretary
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Jacqueline Tillman
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James B. Burnham
Executive Assistant to the
Chairman, CEA

Col. Charles F. Stebbins
Executive Assistant to the
Chairman, JCS

Gerald Pagano
Executive Secretary
AID

SUBJECT: Versailles Summit Paper on East-West Economic Relations

Attached is a final draft of the Versailles Summit paper on East-West Economic Relations. Unless you have major objections, this paper will be sent to the President for his approval on Friday. Please clear with Henry Nau, 395-6961.

Michael O. Wheeler

Michael O. Wheeler
Staff Secretary

Attachment

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Review 4/5/88

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East-West Economic Relations

SUMMARY

East-West economic relations was a principal topic at the Ottawa Summit meeting last year.

A major result of that discussion was a commitment to support the convening of a high-level COCOM meeting. This meeting was held in Paris on January 19-20, 1982, and achieved important progress on the need to strengthen COCOM.

Two major developments have occurred since the Ottawa meeting.

One is the serious deterioration in the economic and financial situations of a number of the countries of the Warsaw Pact, Poland being the most serious case.

The other is the December 13, 1981, declaration of martial law in Poland, which has seriously exacerbated the Polish economic dilemma.

The Summit countries, working within a united NATO framework, have responded to the Polish crackdown by taking both political and economic steps against the Polish Government and the Soviet Union. Most recently, the United States has proposed that the allies develop a cooperative framework to monitor debt accumulation by Warsaw Pact countries and to restrict significantly the flow of officially supported credit to the Soviet Union.

The rationale for this proposal is twofold. The eocnomic aspect is that the Soviet Union is becoming a poorer credit risk, and we seek to avoid giving the Soviets the kind of "reverse" leverage over us that Poland has. The strategic rationale is that it makes no sense to extend official or officially-guaranteed credits which all involve a degree of subsidy to help our adversary. The commercial banks have already reacted to the worsening economic and financial situation in the Soviet Union and much of Eastern Europe by almost entirely cutting off long-term financing and sharply reducing short-term lending to most Eastern European countries.

At Versailles the U.S. will be seeking:

-- to endorse the achievements at the COCOM HLM and a commitment to pursue actively the recommendations of that meeting,

-- to bless an arrangement negotiated to monitor and restrain credit to the USSR,

-- to acknowledge the costly trade distortions implicit in "countertrade" (barter) arrangements with Eastern Europe.

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East-West Economic Relations

at the Versailles Summit

Economic relations with the Soviet Union and the Eastern European countries should be consistent with the broad political-security objectives of the Summit. The issues break down into four categories as developed in the paper presented to the Ottawa Summit, East-West Economic Relations: A Purdent Approach:

-- strategic exports

-- foreign policy contingency controls

-- economic security controls

-- economic influence.

Strategic Controls

East-West economic relations was a principal topic at the Ottawa Summit meeting last year. Those discussions contributed to an enhanced understanding of the need to keep economic relations with the Soviet Union and Eastern European countries consistent with the broad political/security objectives of the Summit countries.

A major result of that discussion was the process set in motion by the Summit leaders' agreement to "consult to improve the present system of controls on trade in strategic goods and related technology with the USSR," encompassing a commitment to support the convening of a high-level COCOM meeting. With the agreement of the non-Summit COCOM member governments, the first such meeting in over two decades was held in Paris on January 19-20, 1982, and achieved important progress on the need to strengthen the COCOM system by (1) establishing a better basis for setting embargo limits; (2) ensuring that critical military technologies are covered by, and non-critical ones deleted from, current embargo lists; (3) giving priority attention to providing embargo to specific strategic areas, such as dry docks, robotics, and space launch vehicles; (4) strengthening embargo enforcement coverage, at both the COCOM and the national levels; and (5) harmonizing national licensing practices and procedures. Activities have been initiated within COCOM to follow up on these agreements.

At Versailles the Summit leaders should:

-- endorse the agreements reached in January

-- agree that priority high-level attention continue to be devoted to the COCOM review activities

-- give highest priority to the serious problem of diversion of embargoes products through non-COCOM countries

-- endorse the need for a more open exchange of information both in COCOM and bilaterally to deal with the growing diversion problem

-- agree to work towards an effective harmonization of their national export control procedures

-- agree to modernize the COCOM infrastructure and communications

-- recommend another High-Level meeting in 1983 to review the progress made during the fall list review and provide additional political guidance

II. Foreign Policy Contingency Plans

At Ottawa, the Summit countries discussed contingency controls and the importance of collective action if Soviet interference in Poland mounted. The allies agreed on the importance of coordinated, joint action, particularly in the event of a Soviet invasion of Poland. The GOP declaration of martial law December 13 and ensuing crackdown posed a direct challenge to the Alliance and required a unified Western response.

The NATO allies reacted with a series of individual economic and diplomatic measures agreed on at the ministerial session of the North Atlantic Council on January 11. On the economic side in particular, some countries decided to suspend further commercial credits for Poland and negotiations on 1982 debt and adopted measures directed at the USSR in the areas of imports, maritime and air agreements and commercial representation. Each of our countries acted in accordance with its own situation and laws, but the message was the same: our countries would not continue business-as-usual and would re-examine economic and commercial relations with Poland and the USSR in light of Polish events.

The Summit countries should reaffirm the view discussed last year that foreign policy controls work best when they are applied collectively. To this end, these countries should continue to coordinate closely on further steps that might be taken together if the situation in Poland should deteriorate or a crisis elsewhere occur.

III. Economic Security and East-West Debt

Western economic security is impaired to the extent the Soviets can exercise economic leverage and the West becomes vulnerable to Soviet actions. At the Ottawa Summit, the U.S. raised the issue of the Siberian gas pipeline, European dependency on Soviet energy supplies and the leverage such dependency will accord the USSR. It also expressed concern about the hard currency the Soviet Union would earn and the contribution this would make toward facilitating acquisition of Western technology and the Soviet military buildup. The U.S. continues to believe that the pipeline decision was unwise. To reduce our potential vulnerability it is most important that priority attention be given to the development of appropriate safeguards as well as alternative sources of energy.

The subsequent Polish financial crisis has underscored another source of Western vulnerability and Soviet leverage; the existing large stock of Soviet and Eastern Europe debt owed to the West. There are two issues involved here: one is the existing debt and the attendant financial difficulties it can pose for the West; the other is the need to reassess government policies in order to avoid Soviet debt from increasing and the reverse leverage which this provides the Soviet Union.

The Debt Situation in Eastern Europe

1981 was a watershed year in East-West financial relations highlighted by the Polish financial crisis, the difficult Romanian situation, and by the general erosion of Eastern European creditworthiness. Poland declared a moratorium on debt service in March and opened negotiations with official and private creditors on debt rescheduling shortly thereafter. By the end of the year, Romania had accumulated $1.2 billion in debt arrears and began negotiations with commercial banks for rescheduling its debts. Even the Soviet Union, faced with a rising agricultural import bill and stagnant hard currency exports, encountered an unprecedented liquidity bind.

Western banks, reacting to the rapid economic and political deterioration in Poland, heightened political concerns over East-West relations in general and instability in Eastern Europe, began applying the brakes on new medium and long-term lending to Eastern Europe in 1981. Syndicated Eurocurrency loans dropped from a peak in 1979 of just under $7 billion to just under $3 billion in 1981 and there have been no major Eastern European syndications since the spring of 1981 when Hungary and the GDR completed $400 million and $100 million Eurodollar loans, respectively. In response to the declaration of martial law in Poland, allied consideration of new credits and a 1982 rescheduling was suspended.

In the aggregate, gross Eastern European and Soviet debt grew from $8.4 billion in 1971 to over $80 billion in 1981, a ten-fold increase. The USSR and Poland hold over 50% of this debt -- about $20 billion and $26 billion respectively. Eastern European debt service ratios are extremely high: more than 150% for Poland, about 70% for GDR and more than 30% for others (excluding USSR and Czechoslovakia, the latter of which has a small external debt). In contrast, reserves are quite low: about $5 billion for the Eastern European countries (excluding the USSR).

Debt owed Western government creditors or guaranteed by Western export agencies represents about one third of total Soviet and Eastern European indebtedness, although the relative importance of official and private debt varies widely from country to country. In Poland and the USSR, official debt represents 52% and 40% respectively of total indebtedness; however, official debt is a relatively small part of total indebtedness for other Eastern European countries.

Short and Long-Term Prospects

Eastern Europe's 1982 debt service bill amounts to $31 billion, including $6 billion in interest alone. Even assuming a roll over of the short-term component of this debt $11 billion, additional cutbacks in hard currency imports, and drawdown of reserves, Eastern European countries will endure a severe financial squeeze and will have to undertake painful adjustment measures. Poland is insolvent; Romania is dealing with a severe short-term liquidity squeeze, and Hungary is now under pressure. Only Czechoslovakia and Bulgaria, both with relatively small outstanding debt, appear better able to weather the current credit squeeze for the time being. Long-term Eastern European economic prospects appear bleaker still, now that the Western credit prop for the inefficient, overly centralized Eastern European economies and Soviet raw material, fuel and food subsidies is being cut back.

IV. Economic Influence: The Soviet Situation and the Importance of Western Finance

The Soviet Union is experiencing increasing financial difficulties. Even though they have some $25 billion in gold stocks, there are limits as to how much of this can be utilized to meet its external obligations. Any attempt by the Soviets to sell large amounts of gold can only serve to depress further an extremely soft gold market. The Soviets know this and this explains in part their reluctance to sell gold in world markets as a means to meet their hard currency needs. The market also knows this and in part this explains its perceptions of the Soviet Union's declining creditworthiness and its reluctance to undertake any new private unguaranteed loans for extended periods of time (e.g. more than a year). The Soviets also have some $5-6 billion in deposits in western banks, considerably down from about $8 billion last year and yet another indication of its weakened position. This money is being utilized for financing short-term trade credits (less than 1 year) and cannot be seen as a source of finance to meet outstanding debt payments.

Juxtaposed against this situation, the Soviets are being squeezed by virtue of the fact that the market for their major source of foreign exchange, oil, is extremely soft and is likely to remain so for the near term. This, coupled with a need to sustain a fairly high level of imports, and to meet increasingly the economic needs of some of its satellite states, places them in an extremely difficult economic and financial situation. With each day we see increasing evidence of the Soviet squeeze. Bankers continue to turn down requests for medium-term finance, requests for short-term finance are now being made for up to 180 days or more rather than 60-90 days as was the case just six months ago, and the Soviets are delaying and stretching out wherever possible payment of existing debts. In addition, to these immediate financial problems, there are increasing signs that the underlying weaknesses in the Soviet's inefficient non-market economy are beginning to show and point toward a secular decline in Soviet economic performance.

Thus the financial choices facing the Soviets provide an unusual opportunity to use credit policy as a means to compel Moscow to pay the true cost of credit and thereby force Moscow to make tradeoffs among its key priorities -- enhancing the military, feeding the population, improving the civilian economy, sustaining its Eastern European allies and expanding its overseas influence. Western countries can reduce the flow of capital to the Soviet Union by regulating the availability of government-guaranteed credits. This will serve to avoid the possibility that official credits may fill the gap being created by private market withdrawal.

Availability of Credits

Our data show that the Soviets borrowed $3.6 billion in private unguaranteed medium and long-term credits and another $6 billion in short-term credits in 1981. Private credits thus accounted for about 80% of total new borrowing of $12 billion. Private capital market reactions to the situations in Poland and Romania, the missing Soviet "umbrella", and decreasing creditworthiness have already led to a retrenchment in new bank lending to the USSR , a shortening of loan maturities, and increased interest rates. The Soviets have not been able to borrow on the Eurodollar market since May 1981.

Official Western credits and guarantees to the Soviets amounted to about $2.5 billion in 1981 and are estimated at another $2.0 billion in 1982 (not counting $2.0 billion in Yamal pipeline credits) -- about 6% of total expected Soviet hard currency imports. The FRG, France, UK, Italy, and Japan account for about 80% of the official credits, which are generally used to finance major plant and equipment exports.

The December 13, 1981, declaration of martial law in Poland has had ramifications for the Soviets. The Summit countries, acting both unilaterally and in various multilateral forums, have responded to the Soviet Union's role in the Polish crackdown by taking both political and economic steps against the Soviet Union. This has served to heighten the commercial banks' concerns about economic conditions, and to weaken further the Soviets already shaky economic and financial conditions.

Credit Subsidies

Roughly 40% of the USSR's outstanding debt carries terms which are below commercial market rates. Current minimum lending rates under the OECD credit arrangement are 10.5 to 11.0 percent (for Category II countries) depending on the term of the loan. Replacing concessional with market interest rates on the roughly $2 billion a year the USSR now receives in official, medium-term financing could raise Moscow's cumulative debt service costs in both the short and long run. The amounts involved taken by themselves are not large; their cumulative effect coming on top of an already difficult situation will not go unfelt by the USSR. In addition, the $14 billion in Yamal pipeline credits were accorded by the West Europeans and Japanese at under 8% interest with maturities of up to 8½ years. While Western firms have reportedly compensated for some of the subsidy by raising the prices of exports for the Siberian pipeline, the differential with private market financing is worth over $4 billion to the Soviets over the payback period of the loans.

Negotiations are already underway within the OECD Export Credit Arrangement that could result in a general reclassification of certain countries, including the USSR, from Category II (intermediate) to Category I (relatively rich) countries. This would result in raising the minimum lending rates to 11 or 11.25% depending on the term of the loan. In addition, we are also seeking a general increase in the Arrangement matrix of minimum interest rates. And this could serve to further increase the cost of borrowing to the Soviets.

V. U.S. Proposal

Against this background, the United States has proposed that the allies develope a cooperative framework to restrict significantly the flow of officially supported credits to the Soviet Union. This proposal was outlined by the mission of high-level U.S. government officials which visited a number of European capitals in mid-March and in alternate bilateral contacts with the governments of other countries.

The rationale for this proposal is twofold. The economic aspect is that the Soviet Union is becoming a bad credit risk and we want to put Western relations with it on a sound private market footing. In doing so, we would avoid giving the Soviets the kind of "reverse" leverage over us that Poland has. In the process, we would make their economic choices more difficult at the margin. The strategic rationale is that it makes no sense to extend official credits to our adversary, replacing financing withheld by private lenders. Moreover, the marginal choices referred to above could involve cuts or, perhaps likely, smaller increases in defense expenditures by the Soviets.

The United States places a great deal of importance on achievement of an agreement along these lines, and will pursue vigorously bilateral discussions to develop the specifics of our proposal. We expect that the process will be sufficiently advanced so that the Summit participants will be able to endorse arrangements for exchange of information on credit flows to Eastern Europe and the Soviet Union and for restraints on official credit to the Soviet Union.

VI. Additional Considerations: Countertrade

Countertrade may be generally defined as an international trade transaction where sellers are obliged to accept a supply fo products from the purchasing country in partial or total payment. Examples of countertrade are straight barter transactions, buy-back agreements where turnkey facilities are paid for by a plant's resultant output, and parallel but separate contracts linking sales to purchases.

The practice has been long promoted by many East European governments who have seen it as a way to reduce hard currency expenditures for needed Western equipment and technology and at the same time find Western markets for their frequently second rate manufactured goods. The East has even tried to promote the idea that long-term countertrade arrangements are a higher form of economic relations between countries because of their "lasting character."

The Soviets have been the largest and most frequent participants in countertrade arrangements, particularly in the energy and chemical sectors. The Romanians have come forth with probably the most burdensome requirements stipulating that Western imports must be balanced by counterpurchases up to 140% of the value of the export contract. The success of Eastern countries in inducing Western firms to enter into countertrade arrangements has also recently encouraged certain LDCs such as Indonesia and Brazil to try and boost exports by introducing counterpurchase requirements.

Summit governments have often criticized countertrade in principle but have not actively discouraged the practice. However, concerns within the OECD, particularly by smaller countries, has led to a closer examination of the phenomenon. Member governments endorsed an OECD study made public in the fall of 1981 which reached the following conclusions:

-- Prospective Eastern payments deficits and lack of competitiveness will result in continued strong pressure on Western firms to enter into countertrade arrangements.

-- Western countries should not adopt an attitude of benign neglect towards these practices. Countertrade practices entail unnecessary complications in the transaction process, introduce additional trade risks for Western firms, and accentuate bilateralism in East-West trade.

-- Western countries should analyze the countertrade phenomenon more thoroughly.

-- Better statistical coverage of countertrade deals is necessary

Western steps to discourage countertrade would be timely. Governments should also consider if measures such as the withholding of government credits and credit guarantees and the erection of special barriers to deal with possible import surges resulting from countertrade would be appropriate.